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GST AND PROPERTY - A PRELIMINARY STUDY

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This paper is aimed at giving an introduction to the discussions on GST and its effects on property. As pointed out in the paper there have been over 1000 amendments to the GST legislation since its introduction and there are many others currently being debated.

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Introduction

From 1 July 2000, the Australian Commonwealth Government will be introducing a "New Tax System" which will include a range of tax reforms. The major element of the New Tax System will be the introduction of a broad-based Goods and Service Tax (GST).

The new tax will be broad based in that it aims to tax all expenditure on goods and services. Accordingly, it will have implications for property as among other things, the tax will be imposed on new construction, renovations and refurbishment, the transfer and rental of non-residential property.

The rate of the GST will be 10% on the supply of most goods and services consumed in Australia, however the liability to pay the tax will rest with the supplier of such goods and services. Hence, property will attract GST in construction, renovation and refurbishment, in transfer of ownership and in rental income for non-residential property. It will also affect the professional in the industry, such as the valuer, property consultant and agent when charging for services.

As the tax has not yet been introduced and there are several unanswered ambiguities regarding the tax, particularly in the property sector, this paper is only a preliminary study and will endeavour to identify all the areas where GST will affect the property industry. At present, the treatment of GST on local government rates and taxes and state government stamp duty remain unclear.

With more research and clarification of the many amendments and unanswered anomalies, it is envisaged that the authors will publish a *monograph* on the topic.

Definitions

- **Important dates**

The following dates are significant in assessing GST liability during the transitional period.

2 December 1998 - GST legislation was introduced into Parliament
8 July 1999 - GST legislation received Royal Assent
1 July 2000 - Commencement of GST

The transitional period is relevant for transactions which commence prior to the commencement date and span beyond it.

- **Input Taxed Supplies (also referred to as Input Taxed)**

No GST added, but no GST *input tax* credit available for supplies. Included in this category, are financial supplies, residential rents etc.

- **Input Tax Credit**

The amount allowed to offset the GST included in the acquisition price if it was acquired for use in an enterprise (ATO, 1999).

- **Price**

From 1 July 2000, all prices must have GST inclusive, that is the price quoted will include GST - 1/11th of the total price will be GST and 10/11th for the supplier of the good or service.

- **Registration**

Entities (includes individuals and corporations) carrying on an enterprise which have an annual turnover of $50,000 or more ($100,000 for non-profit entities) must register and those below the threshold may choose to register. Only those registered can claim the *input tax* credits for GST that is paid on supplies required to carry on the enterprise. Hence, large property owners (> $50,000 non-residential rental income) will be required to register, whilst smaller owners may also choose to register so as to obtain *input tax* credits.

- **Tax Rates**

The introduction of the GST under the New Tax System will result in a reduction of both personal and company tax rates. Table 1 shows the existing and new rates of personal income tax effective from 1 July 2000.

Table 1

Existing & New Rates of

Personal Income Tax Rates

Existing Rates	**%**	**New Rates**	**%**
$0-5,400	0	$0-6,000	0
5,401-20,700	20	6,000-20,000	17
20,701-38,000	34	20,001-50,000	30
38,001-50,000	43	50,001-60,000	42
50,001-plus	47	60,001-plus	47

Company tax rates will be reduced from 36% to 34% in the 2000-2001 fiscal year and further reducing to 30% from 2001-2002 onwards.

Construction

All construction after 1 July, 2000 will be subject to GST. Similarly, all renovations (including residential) will be subject to GST on the goods and services. The same applies to repairs and maintenance

GST will apply to all of the building cost for construction that begins after 1 July, but will not include the land price if the vendor owned the land before that date. If the land is bought after July 2000 it is expected to be taxed, along with the house.

Vendors of newly constructed properties will be subject to GST and will receive *input tax* credits for GST paid on inputs from sub-contractors and consultants. Charges for water supplies, sewerage and drainage services will be GST-free.

Table 2, shows how GST applies to a developer building a house and then selling it to a consumer. Column 2 calculates the GST paid at each interval (that is, GST less *tax input*) and the final column shows the amount paid to the Australian Tax Office (ATO).

Table 2

Example of GST on Construction

	GST less *input tax* credit	**$**	**GST (ATO)**
Building material supplier: Sells materials to subcontractor for $11,000 including $1,000 GST	GST on sales Less *input tax* credit GST to pay	1000 0 1000	 $1000
Subcontractor: Supplies material & labour to developer for $15,400 including $1,400 GST	GST on sales Less *input tax* credit GST to pay	1400 1000 400	 $400
Developer: Supplies completed house to buyer for $165,000 including $15,000 GST	GST on sales Less *input tax* credit GST to pay	15000 1400 13600	 $13,600
Total GST			**$15000**

Hence from Table 2, we see the supplier pays the $1000 GST to the ATO. The subcontractor is entitled to an *input tax* credit for the $1000 GST included in the price paid to the supplier. The sub contractor offsets this credit against the $1400 GST payable on the supply to the developer and pays $400 to the ATO.

The developer is entitled to an *input tax* credit for the $1400 GST included in the price paid to the subcontractor. The developer offsets this credit against the $15,000 GST payable on the supply of the house to the purchaser and pays $13,600 to the ATO.

As consumers of residential property cannot claim *input tax* credits for GST, they bear the entire GST of a newly constructed house.

Transfer of Property

Where GST is applicable on the sale of property, all advertised prices must be inclusive of GST. GST will apply to all incidental costs that are associated with the selling of all types of properties. This will include fees charged by agents, valuers, solicitors, surveyors, pest and building inspectors, accountants financial advisers etc.

Table 3 shows the before and after GST of a vendor selling a property $500,000. Before GST the vendor would be receiving $482,500 and after GST would receive $480,750 and the difference ($1,750) is the GST.

Table 3

GST on Sale of Property

	$	**$**	**GST**
Purchase Price	500,000	500,000	
Less			
Agent's Commission (3% /3.3%)	15,000	16,500	1,500
Advertising	1,500	1,650	150
Legal fees	1,000	1,100	100
Total	**$482,500**	**480,750**	**$1,750**

<u>Residential</u> **–** this includes land or a building occupied or intended to be occupied as a residence.

The sale of residential premises will generally be an input-taxed supply (ie exempt for GST). The purchase of a new home or residential land after 1July 2000 from a registered entity (such as a builder or developer), will attract GST.

To compensate the GST impact on residential properties, under the First Home Ownership scheme a $7000 cash bonus (non-means-tested) will be available for those who have not previously owned a home.

<u>Commercial Residential Premises</u> – this includes hotels, motels, inns, hostels, boarding houses, caravan park and camping grounds.

The sale of commercial residential premises is generally subject to GST however the sale of property as a going concern will be a GST - free supply if certain requirements are satisfied. This includes: that the purchaser must be registered or required to be registered for GST; the supplier must carry on the business until it is sold; all of the things required for the continued operation of the business must be supplied; and both parties must agree in writing that the supply is of a going concern (ATO 1999 (a), p37).

<u>Commercial Premises</u>

Registered vendors: GST will apply to the sale of all new or existing commercial property from 1 July 2000. (ATO, 1999 (c), p29).

Unregistered vendors: If a vendor is not registered for GST, then GST is not payable on the sale.

Margin Scheme

The margin scheme allows for a reduced amount of GST to be paid. The scheme will apply to the supply of freehold interests in land, strata units and long-term leases. Long term leases held prior to and continuing past 1 July 2000 are also included.

The GST calculation on the margin of a supply is derived by calculating the sale price (including GST), less the original purchase price or if the property was held at 1 July 2000, the valuation of that property at that date. This does not include the cost of any improvements to the land made on or after 1st July 2000 when calculating the original purchase price. The GST is thus calculated as 1/11th of that margin.

<u>Sale of Property</u>

The margin scheme cannot be used if the property was acquired through a taxable supply where GST was calculated without using the margin scheme.

Example:

(a) A property developer buys a block of land in September 2000 where GST was not calculated using the margin scheme and claims an *input tax* credit for the GST included in the purchase price. The developer would not be able to use the margin scheme when selling the property (ATO, 1999a, p29).
(b) If the developer buys the block from a private owner, no GST would have been included in the price and no *input tax* credit would be available. In this case, the developer would have the option of using the margin scheme when calculating the GST payable on the subsequent sale of the property (ATO, 1999a, p29).

Note: The purchaser cannot claim an *input tax* credit if the margin scheme is being used regardless of whether the property is commercial or residential.

Long Term Lease or supply of a freehold interest strata unit

The GST can be calculated on the full value of the supply or on the margin provided that you are registered or required to be registered for GST.

Table 4 shows a comparison of using the margin scheme as opposed to the normal method for property developer selling a block of land.

The developer aims to achieve $100,000 and using the normal method for GST the property developer would need to sell the block for $110,000 to cover the GST payable on the sale. The GST would be 1/11th of the sale price, $10,000.

However, under the margin scheme the property developer could sell the block for less than $110,000 and still clear $100,000. Assuming the block is valued at $80,000 as at 1 July 2000, under the margin scheme GST is only calculated on the difference in value between 1 July 2000 valuation and the final sale price. If the developer sells the block for $102,000, the margin is $22,000. The GST payable on the margin is 1/11th of $22,000 being $2,000 that the developer has to pay to the ATO.

The developer would therefore be able to market the block at a lower price of $102,000, and make the price more attractive to prospective private buyers who cannot claim an *input tax* credit.

Table 4

Margin Method vs ordinary method

	GST ON FULL VALUE		**MARGIN SCHEME**	
Purchase Price	Inclusive of GST	$ 110,000	Exclusive of GST	$102,000
Less Value of land 1.7.2000				80,000
Margin				22,000
GST to ATO		**$ 10,000**		**$ 2,000**

Source: ATO Page 31 Publication C

Auctions

As discussed above, GST on sales applies to commercial properties and to all new properties where the owner is a registered entity.

In a sale by auction, the auctioneer should know prior to the auction, if the vendor is registered for GST and if the vendor intends to apply the margin scheme. Hence, before the commencement of the auction, the auctioneer must inform the bidders on the registration status of the vendor and if the property is liable for GST. If GST is applicable, the auctioneer must also inform the bidders the method to be used for calculating GST.

If the vendor has chosen the margin scheme, the auctioneer must inform the bidders that all bids will include GST. The GST is payable by the vendor and calculated at $1/11^{th}$ of the margin. If the vendor is not using the margin scheme, the auctioneer has the discretion in announcing whether bids are inclusive or exclusive of GST. If the property is sold on a GST - inclusive basis, then GST is payable by the vendor and calculated by taking $1/11^{th}$ of the selling price.

If the auction is exclusive of GST and the vendor is registered, GST is added to the selling price. However, if the property is purchased for business use by a registered entity, the purchaser is entitled to an *input tax* credit. This means that the purchaser buying under these conditions is liable for an additional 10% (being the GST) and receives the same as an *input tax* credit.

Leasing of Property

Where GST is applicable to rental properties, tenants paying the GST are entitled to claim it back as an *input tax* credit, provided they are registered. Likewise, registered landlords have *input tax* credits available for costs incurred. If tenants are not registered, the GST becomes an extra cost and can only be claimed as an additional deduction for rent in the normal tax assessment (ATO, 1999).

Residential Property

In general terms residential tenancy, that is the property which is used solely as a residential tenancy is GST exempt. Landlords of these properties will not be able to obtain *input tax* credits (that is claim back) the GST paid on inputs and will only be able to claim it as a tax deduction in their normal tax assessment. Hence, the impact of the GST will effectively mean a lower net return for the landlord and rents may increase as owners endeavour to maintain their returns.

Where a residential property is leased on a "short term serviced apartment letting", that is similar to a hotel letting, such residential leasing will be subject to GST. This applies to both units (condominiums) and houses and will particularly be relevant with many of the serviced lettings for the Sydney 2000 Olympics. In other words, these properties will be treated like the commercial properties, which are dealt with in the next section.

Commercial Property

The rental of all new leases of commercial property of registered entities will be subject to GST and accordingly will obtain *input tax* credit on goods and services paid in earning such rent, such as repairs, managing agent's fees. Small scale landlords (annual turnover of less than $50,000) are not required to register and accordingly are not subject to GST, however these landlords will not be eligible to claim back the *input tax* credit [Redford, p28].

It should be understood that in adding the GST to the rent, the tenants (if registered) are also eligible to claim back *input tax* credits. In other words, the tenants pay the extra *implied rent* (GST) to the owners and claim it off the GST paid on their own sales or services rendered which are also subject to GST. If the *input tax* credits are greater than their own GST, the tenants will receive a refund. As an example, if the tenant is in medical practitioner, then his/her services are exempt from GST however all GST paid on supplies would be refunded as *input tax* credits.

Transitional Period

Some of the biggest nightmares for professionals arise in the transitional period. Treatment of transactions taking place during this period are highlighted in the "A New Tax System (Goods and Services Tax Transaction) Act", known as the "Transaction Act".

Beavis (1999, p59), claims that sales in progress (including "off the plan" sales) which take possession after 1 July 2000 are subject to GST. However it remains unclear whether properties (which are not being developed) and have had an "exchange of contracts" before the commencement date and settle after it are liable for GST.

As we are dealing with property, we will deal with construction and the leasing of property during this period, professional fees during this period are also treated under the next section.

- Construction

All construction of property that has commenced before 1 July 2000 and is ongoing after the commencement date will require an updated valuation of construction to that date. The method of valuation is to be determined following industry input and a discussion paper. The preferred method of the Australian Tax Office is to use the method of valuing "progress payments" and excluding unfixed materials on or off the site (Davis, 1999);

"the value of all work and materials permanently incorporated in or affixed on the site of the building work must be determined as at 1 July 2000. GST is only payable to the extent that the value of the supply exceeds the value determined as at 1 July 2000".

For the purposes of these "transitional valuations", the Act recognises architects, civil engineers and quantity surveyors as well as property valuers.

- Commercial leases

This section deals with the leases of properties where the landlord is a registered entity (see definition above).

Commercial leases (where the landlords are registered) which have been in place before the "Royal Assent" (8 July 1999) are exempt until 1 July 2005 or a market review whichever occurs first. This applies to written agreements only, that is any lease running past 1 July 2000 made on the basis of a "gentlemen's agreement" will be subject to GST no matter when it was made (Redford, p32, 1999).

Leases entered after the Royal Assent and before the commencement date and extend beyond 1 July 2000, will automatically become subject to GST. However, if the lease does not have a suitable recovery clause, the landlord's rent will be treated as *inclusive*, which means 1/11th of the rent will be paid to GST. The tenant in this scenario, if registered, will receive the equivalent benefit in the form of an *input tax* credit.

Leases entered into before the Royal Assent, once reviewed are subject to GST, however the question is whether in the market review, a landlord will be entitled to add the 10% cost of GST. That is, a market review implies that the rent be determined according to the market (comparable rents etc), does this incorporate GST or not?

The matter will probably be determined in the courts sometime in the future. On the one hand, the argument is that as the comparable properties have

$$\$x \text{ (rent)+GST} = \$y \text{ (total rent)},$$

then in a market rent review, you can accept $y. But on the other hand, the argument is that in a rent review you can only determine the review based on the "existing terms and conditions" of the lease and if the lease does not explicitly state any increases in taxes or new taxes then you can only use $x in the comparable. If the latter method is adopted, the rent would be treated as *inclusive*, and the landlord would then be paying the GST out of the rent whilst the tenant would receive the *input tax* credit (provided they are registered).

Furthermore, landlords with very long term leases (>10 years) extending well beyond 1July 2005 and containing no review opportunity (such as large leases to many of the major tenants of shopping centre or CBD office buildings) will have their rent treated as *inclusive* after that date. In other words, they will effectively be receiving 1/11th less from that date. Redford (p34, 1999) estimates the loss to these landlord be "many million of dollars" to these landlords by "virtue of the 1 July 2005 sunset date" and windfall gains of similar amounts to their tenants (with the exception of *input tax* tenants).

The transitional period becomes even more complicated as Redford (p33, 1999) points out on a lease which was entered into before the Royal Assent and has an option to purchase clause. In these leases, it is unclear whether a sale made between 1 July 2000 and 1 July 2005 is subject to GST or not.

Another matter, which **remains unclear**, is the sale of property whereby an "exchange of contracts" has taken place and thereby ensuring a sale, but the settlement takes place post 1 July 2000. Because settlement is deemed to be the effective date of supply, GST should be applied.

Professional Fees

All professional fees earned after 1 July 2000 are liable for GST and accordingly, this includes agent's commissions in property transactions. As real estate agent's commissions on sales and leasing transactions are taxed when earned (that is, on settlement and not on billing), this will require agents to be cautious in the period leading up to the effective date. Real estate agents will need to obtain new "agency agreements" with GST added to their standard commission rate, otherwise the commission will be treated as *inclusive* and they will be liable to pay the GST out of their commission.

For instance, UTS Realty lists a property for sale for $550,000 in May 2000 and accepts the agency on a flat 3% commission. If sold at the asking price, the agent would receive $16,500, however if the sale is settled after the 1 July 2000, the agent will be required to pay $1,500 GST (1/11th) and will not be entitled to claim it back from the vendor. If however the agency agreement stated that "if the sale was to settle after 1 July 2000, the commission rate would be 3.3% (GST inclusive) the agent would receive $16,500 for the sale, $15,000 for the agent and $1,500 for the GST. The effect on the vendor depends on whether the entity is registered or not. If the vendor is registered, the GST is treated as *input tax* credit. But, if the vendor is not registered, the vendor pays an extra $1,500.

Hence, the prudent agents should be adding the GST to their commission rates, that is having a schedule fee on sales of 3.3%.

In cases where the vendor is registered, the GST is neutralised and should not pose a problem, however, where the vendor is not registered (as would be the case in many of the residential sales), the vendor is paying an extra 10% on the commission fee. Undoubtedly, vendors will be trying to negotiate the agents to absorb the GST and depending on the state of the market, some agents will absorb the cost whilst others will not.

The same applies to management agency fees whereby the agent receives a percentage of the rent as a fee for services. These are generally signed at the beginning of an agency and can be ongoing for years. Hence agents should be beginning to have all their managing agency agreements re-signed with GST added to their fee structure otherwise they will also effectively be paying 1/11th of their fees to the GST.

Conclusion

As has been discussed GST will have a major impact on property. The total impact cannot be assessed until such time as all the issues are clarified.

One early assessment that can be made, is that the price of new residential property, in particular, will rise as buyers will bear the brunt of the GST and will not have *input tax* credits available to them.

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